Active vs. passive mutual fund investing

Guide

Offering you a balanced view of active and passive investing

Find out whether one or both of these strategies may be right for you.

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Both active and passive mutual funds provide important benefits.

Without realizing it, many investors develop a bias toward either active or passive investing. It may be because of an incomplete understanding of these strategies or the way they're sometimes positioned.

Active and passive investing are both valuable strategies for building wealth, and they often work well in combination. With this guide, we'll help you learn more about them and make it easier for you and your advisor to discuss what's best for your portfolio.

What to look for inside:

3 **Understand the difference between active and passive fund management**

4 **Know the times and places where each one has an advantage over the other**

5 **Learn how a balance of the two strategies may broaden your diversification and improve your returns**

Understand the difference between them.

Active fund management

This is where the portfolio manager researches available stocks or bonds and selects specific ones for the fund. The goal is to realize returns that are better than those achieved by the index the fund uses as a performance benchmark.

Example
An actively managed small-cap stock fund might invest in 125 securities and focus on beating the performance of the Russell 2000 Index.

Advantages	Disadvantages
Opportunity to outperform the index	Fees are often higher to pay managers for research and security selection
Flexibility to adapt to changing market conditions	Relies on manager's ability — some are better than others

Passive fund management

This is where the portfolio manager doesn't make specific investment choices, but instead mirrors the fund's benchmark — it buys all the stocks or bonds included in the index. The goal is to simply match the returns achieved by the fund's benchmark index.

Example
A passively managed large-cap stock fund might track the performance of the S&P 500 Index by investing in all 500 stocks found in that index.

Advantages	Disadvantages
Fees are often lower since the security selection process is automated	Inflexible — cannot adapt to changing market conditions
Performance of the fund is sure to be in line with performance of the index	Limited opportunity to outperform the index

Know when one may outperform the other.

Actively managed funds

These funds tend to perform better during bear markets, when security prices are declining and investors are generally pessimistic about the future.

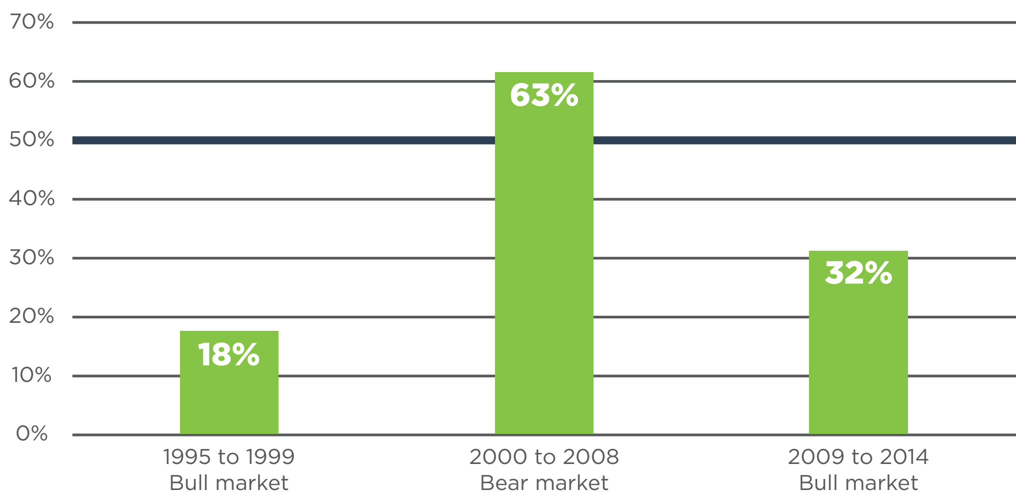
At these times, we often see more fluctuation in the prices of securities and a wider range of returns within market sectors. As a result, portfolio managers are able to use their knowledge and resources to help identify the best investment opportunities.

Passively managed funds

These funds generally perform better during bull markets, when security prices are rising and investors are confident that the trend will continue.

Because they tend to hold many securities and stay fully invested to mirror their benchmark index, these funds often benefit from security prices that are more stable and steadily increasing as the broader market moves higher.

Percentage of actively managed funds outperforming their index during different market environments[1] — 1995 to 2014



[1] *The Case for Actively Managed Funds*, The Wall Street Journal (February 8, 2015).

Past performance does not guarantee future results.

Recognize where each one may have an advantage.

Actively managed funds

Actively managed funds often have more success in asset classes where there is more inefficiency, meaning factors exist that may cause some stocks or bonds to be inaccurately priced and create opportunities for portfolio managers.

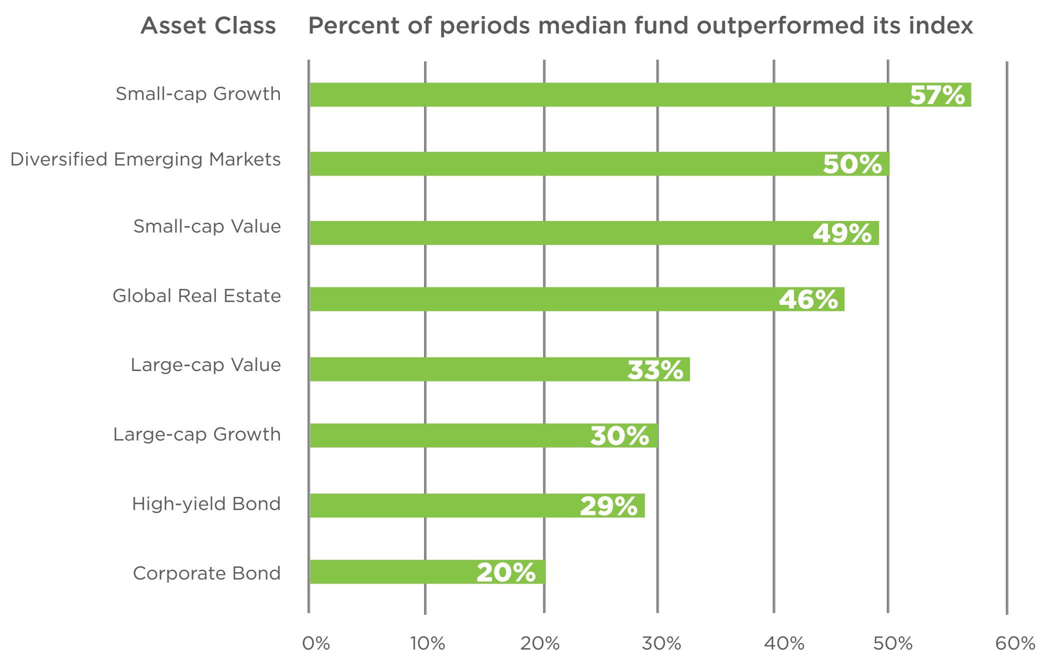
- **Small-cap funds** offer opportunity because companies are earlier in their growth cycle and business models are more diverse
- **International funds** may do well because they can proactively select securities from countries showing more promise and hedge currencies

Passively managed funds

Other asset classes that are more efficient, where prices tend to reflect the true value of the securities, make it more difficult for active fund managers to beat their benchmark and may favor passively managed funds.

- **Large-cap funds** offer opportunity because there generally isn't as much variation in returns among large companies
- **Bond funds** may do well because fees are a larger percentage of their total return, so reducing them through passive management can have more of an impact

Success rate for actively managed funds by asset class[2] — 2000 to 2015



Past performance does not guarantee future results.

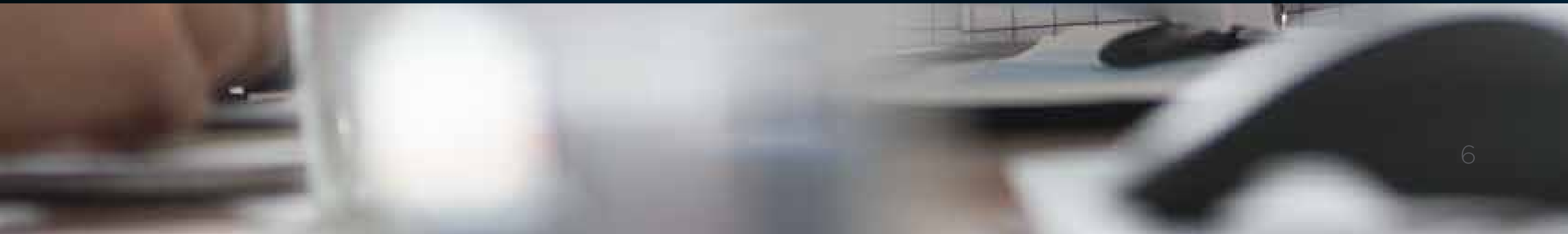
[2] Morningstar. This chart reflects data from various one-, three- and five-year periods between 2000 and 2015. 139 distinct observations per asset classes were included.

A balance between the two may be the way to go.

Including both actively and passively managed funds in your portfolio may help improve its performance because the combination will let you:

- Take advantage of the broad exposure and lower fees offered by passively managed funds
- Potentially beat the market and protect against bear market losses with actively managed funds

As you discuss your options with your advisor, be sure to consider whether this combination approach may be right for you.



Key things to remember:

1 | It's important to understand the difference between active and passive fund management

2 | There are times and places where each one may have had an advantage over the other — it's situational

3 | An appropriate balance of both actively and passively managed funds may broaden your diversification and improve your returns

Talk to your financial advisor today to decide what may be best for your portfolio and help you achieve your financial goals.

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